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1. Gustav F. Papanek
- 2.
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# **POVERTY REDUCTION:**

Focus on the Rural Poor and Micro-, Small- and Medium-Scale Firms

**By Gustav F. Papanek**



**Prepared for:**

Bappenas, Republic of Indonesia

**Submitted to:**

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May 2002 – Revised Oct. 02

## **SUMMARY**

### **POVERTY REDUCTION\***

#### **Focus on the Rural Poor and Micro-, Small- and Medium-Scale Firms**

In the last two years the income of most of the poor has been stagnant or declining. It is well below where it was before the Crisis in most Provinces. Raising the income of the poor therefore should have high priority. The key to poverty alleviation is to increase the number of productive jobs for unskilled workers.

#### **A. Speeding the growth of Micro-, Small- and Medium-scale enterprises [MSME]**

MSME are labor-intensive, so their growth can make an important contribution to job creation.

Measures to increase the growth of MSME:

1. To expand *financial services to micro-enterprises and agriculture* requires that they do not have to travel great distances to make deposits or get credit. *Government should provide a one-time subsidy to cover most of the start-up costs of any financial institution setting up new facilities in areas without service.*
2. Expanding *credit for small & medium enterprises* requires incentives for financial institutions to look beyond borrowers with adequate collateral and who need working capital. Many institutions are eager to lend to such traditional borrowers. To provide an incentive for innovative loan programs *a subsidy is proposed for the start-up costs of programs that lend for the longer term; or to those without assets but with a good cash flow; or for new enterprises; or other innovations.* The subsidy would be for such start-up costs as: training for specialized staff; office costs of specialized units; setting up in new locations. Financial institutions would be eligible if they will charge market interest rates and their NPL are below 7%.
3. *Venture capital for SME.* To provide to venture capital for smaller firms government should *invite one or more successful venture capital firms to operate in Indonesia*, risking their own capital, with *government sharing the risk* for investment in smaller firms.
4. It is important to *end policies that undermine the viability of the credit system:*
  - a. *Interest rate subsidies* are not needed, lead to KKN, undermine the large credit programs that charge market rates and are a drain on the budget
  - b. *Loan write-offs* suffer from the same problems and are an incentive not to pay back loans
  - c. *Forcing banks to lend to SME* will result in bad loans, losses and inefficiency.
  - d. *Financing for recommended subsidies* can come from ending counterproductive subsidies and from raising fees on banks
5. *Controls, regulations, taxes and fees on business are especially difficult for smaller firms*

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\* NOTE: This paper was prepared by Dr. Gustav F. Papanek while he was a Short-Term Consultant supplied by BIDE [Boston Institute for Developing Economies] as part of the PEG [Partnership for Economic Growth], a joint project of USAID and the Government of Indonesia. Of course, he is solely responsible for the analysis and recommendations of this paper.

- a. *Provide financial incentives to Kabupaten [and Provinces] to reduce controls and regulations, especially on SME [e.g. move to one-stop registration of new business]*
- b. *Strongly prohibit interference with internal trade by a Constitutional amendment*

6. *Technical assistance [TA] and business services*

- a. *Government has generally failed to provide services efficiently*
- b. *Subsidize and support private business services.* First, continue and expand the small successful [Swissconsult] program to for private business support services for SME. Second, encourage the private arm of the World Bank and the ADB to invest in private support services for SME. Third, identify emerging industry clusters and publicize them to firms that can provide TA and business services.
- c. *Many SME receive TA and services through suppliers, customers and Trading Houses. Trading Houses are especially important for SME and should be encouraged to operate in Indonesia, not be subjected to restrictions.*
- d. *The importance of organizations of smaller firms.* Individually smaller firms are difficult to reach with TA and services. Geographic or industry organizations make it easier to reach them and for their voice to be heard. *Government should support ongoing programs to organize SME.*

7. *Inadequate and deteriorating infrastructure* are also special problems for SME. The reorientation of KDP and UPP, discussed below and matching grants for infrastructure can both help. For the serious problem of *telecommunications the introduction of competition will help.*

8. *Higher minimum wage seem not to be a problem for small firms*, which have found various ways to deal with them.

9. The special needs of agriculture, the important “employer of last resort”

- a. *Mechanization is beginning in planting*, an important labor-intensive activity and will aggravate the employment problem. It may be possible and desirable to *slow it down by increasing the cost of machinery* through taxes.
- b. Poor producers and consumers suffer from large seasonal changes in rice and other food crop prices. Government should *increase the ability of producers and traders to hold stocks with a system of bonded warehouses* and cash advances on warehouse receipts.
- c. *Credit for agriculture* has the special problem of unclear titles to land. Existing small programs for land titling need to be expanded and accelerated.
- d. *Fostering, not hindering, a shift to crops that Indonesia can produce efficiently* in each region is important for agriculture to contribute most to income and employment. Any tariffs should be comparable across competing crops.
- e. Agricultural processing has great employment potential. One step to realize it is to allow *duty free imported inputs for processors exporting most of their output.*

## **B. Expanding and Reorienting KDP/PPK and UPP/P3KP**

The Kecamatan Development Program [KDP/PPK] and the Urban Poverty Program [UPP/ P3KP] emphasize the role of the poor in decision-making and good governance. They are locally designed and administered, as well as labor intensive. They have been fully funded by the World Bank. Support for any village or city Ward ends after 3 years.

1. For the *KDP/PPK program* to reach its potential in alleviating poverty it needs to be reoriented from primarily an empowerment and governance effort to one that *stresses infrastructure development and employment.*

2. About one-quarter of KDP funds have been used for credit to private business. *KDP is poorly designed to administer credit*, especially to assure repayment of loans. *The credit element should be ended* and the savings used to support infrastructure development.

3. *UPP* also is not financial institution with the ability to collect loan repayments. The credit does not create many jobs. But since *credit is ¾ of the program* ending it would largely end the program. *How UPP can be reoriented needs to be explored.*

4. Reorienting KDP to a permanent program to develop and maintain infrastructure and create jobs would justify that *KDP continue to support kecamatan that have been in the program for 3 years as well as adding new kecamatan every year.* To fund the expanded KDP and a continuing UPP all “graduating” kecamatan/ kelurahan, and those entering either program would be eligible for World Bank [or ADB] funding of 20-30% of program costs, not 100% as in the past, plus all supervision and Technical Assistance [TA] costs; plus special National government matching [DAK] funds for 20-30% of program costs; provided that the relevant kabupaten is willing to provide the remaining 40-60% of program funds. If they are be permanent programs both *need also to be integrated into local governments, while retaining the great achievements of KDP/UPP: a major role for the poor in decisions and transparency.*

### **C. Financing Poverty Alleviation Programs**

1. Limit programs to those with high priority and quick payoff
2. Scale down or eliminate programs that have not been successful
3. Draw on highly concessional donor funding to the maximum extent possible
4. Use matching grants

*In short: the additional funding required would be minimized by focusing on projects that have high priority and quick payoff; some of the funding can be made available by scaling down or discontinuing lower priority or ineffective programs; additional resources can be obtained on a concessional loan basis from the World Bank and the ADB for a coherent poverty alleviation effort; and the National Government can leverage its own resources by providing matching grants to Provincial and District governments for national programs.*

## **POVERTY REDUCTION\***

### **Focus on the Rural Poor and Micro-, Small- and Medium-Scale Firms**

**In the last two years the income of most of the poor has been stagnant or declining and it is still well below where it was before the Crisis in most Provinces.** In the last 2 years the wages of agricultural workers have declined in Java and in several other Provinces and so have wages of urban informal sector workers. In the same areas real wages at the end of 2001 were 20% or more below where they had been before the Crisis. Their wages track quite well what happens to the poorest 40% of the population<sup>1</sup>, justifying the belief that the income of the poor has stagnated or fallen while some other parts of the economy are doing well.

**Raising the income of the poor therefore should have high priority. The key to poverty alleviation is to increase the number of productive jobs for unskilled workers.** The major reasons why real wages and income stagnate below where they had been in 1996/97 is that by now there is a backlog of 10 million or more who entered the labor force in the last 5 years but could not find productive employment. And 2-2.5 million more enter the labor force each year. There is not much open unemployment among the poor because they cannot afford to be unemployed for long. Without the daily income which work brings they cannot afford the food they need to survive. Their problem is not that they have no work; it is that they cannot find work that gives them enough income to lift them above the poverty line. Either they work too few hours in the week, or their rate of pay per hour is too low or, most of the time, they suffer from both.

Because few or no jobs have been created in the economy on a net basis additional workers have crowded into agriculture and other informal sectors occupations where they hardly increase output and simply share in incomes that are essentially stagnant. The poor mostly live by selling their labor, whether they work as agricultural labor on the land of others, as unskilled construction workers or as self-employed sellers of cigarettes or as becak drivers. If they own enough land so they do not have to work for others they will usually not be poor. Or if they are really skilled workers they are also not likely to be among the truly poor.

If there is more demand for the unskilled labor of the poor either they get to work more hours, or the income per hour will rise or, usually, both will happen. The same mechanism works even if they are self-employed. If there is more demand for the services of the cigarette peddler, for instance, the peddler who buys a pack and sells cigarettes by the piece or “stick” will sell more per day and may be able to raise the price. For both reasons he will earn more.

The most important determinant of the number of unskilled jobs created, and therefore of the income of the poor in the medium term, is the rate of growth of such labor-intensive activities as agriculture, services, trade, construction of residences, and of labor-intensive industries, mostly

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<sup>1</sup> See separate paper on “Do Real Wages Track the Well-being of the Poor?” for Bappenas/PEG/BIDE. Both papers prepared while the author was a Short-Term Consultant supplied by BIDE [Boston Institute for Developing Economies] as part of the PEG [Partnership for Economic Growth], a joint project of USAID and the Government of Indonesia. Of course, I am solely responsible for the analysis and recommendations of this paper.



those producing for export [e.g. garments]. But policies and programs to increase growth and especially growth of exports are not addressed in this memo. Rather it focuses on two issues:

- the development of Micro-, Small- and Medium-Scale Enterprises [MSME], including those in agriculture, and
- the labor intensive programs that are targeted on the poor, especially the Kecamatan Development Program [KDP/ PPK] and the Urban Poverty Program [UPP/ P3KP].

In the shorter term of a year or two the real income of the poor is greatly affected by the rate of inflation, especially the price of staple foods that absorb a large share of the expenditures of the poor. But the impact of inflation is also not addressed in this paper. The final section of the paper addresses the issue of how to finance the proposed programs and policies.

### **A. Speeding the growth of Micro-, Small and Medium-scale enterprises [MSME]**

Experience has shown that MSME tend to be very labor-intensive and especially intensive in the use of unskilled workers. Their growth therefore makes a special contribution to the alleviation of poverty. They are also scattered throughout the country and therefore provide broad regional benefits. For these and other reasons their development is seen as especially important in reducing poverty throughout the country. And indeed they can make a substantial contribution to creating productive jobs for unskilled workers. It is often thought there are some simple policies or programs that can quickly increase the growth of these firms by giving them priority in the allocation of credit, or forgiving much of their debt, or granting them priority in supplying the government. But it needs to be recognized that:

- **there is no magic bullet to speed the growth of MSME;**
- **speeding the growth of MSME is not a magic bullet in alleviating poverty.**

The very strengths of the MSME in job creation – their great numbers and wide dispersion – also makes it difficult to assist them. With 2.5-3 million household and small establishments reaching them with services is a difficult task. Credit has been emphasized in many programs but it often is not the only obstacle to their growth; indeed it may not be a serious problem for many who are self-financed. Technical and business knowledge is often lacking, but government programs have been notoriously unsuccessful in supplying them. In general, the most important determinant of the growth of MSME is the growth in demand for the goods or services they supply. In other words the growth of MSME is highly dependent on growth in the economy. **The most important help which government can provide the MSME is to speed the growth of the economy as a whole.** Overall growth in turn depends on macro-economic policies and a political environment that makes it attractive to invest in Indonesia, to increase output and especially exports and to hire more workers.

Because the MSME are substantially dependent on the rest of the economy to provide the demand for the goods and services they produce they are not the “leading sector” in large economies. Even if policies and programs are adopted to help them grow they cannot pull the economy out of slow growth or stagnation nor can they by themselves achieve a rate of growth high enough to provide employment to unskilled workers entering the labor force. But MSME can make a substantial contribution to the creation of productive jobs and the increase in output if they can be assisted to grow more rapidly. Beyond a favorable macro-economic and political environment a menu to help them will include:

- credit and venture capital;
- technical assistance and access to information;
- reduction in controls, fees and other obstacles to trade;
- improvement in infrastructure, especially that servicing MSME.

### 1. Expanding credit to micro-enterprises and agriculture

Indonesia already has the largest and most successful system for providing credit to small and micro-enterprises, anchored by BRI [Bank Rakyat Indonesia]. One problem is that very little credit reaches the very poorest one or two deciles who lack both collateral and credit history. Another key problem for micro-enterprises [defined as those borrowing up to Rp. 1 million] and for many farmers is that they do not have ready access to a financial institution. They need to be able to safely deposit funds as well as to borrow. The amounts of cash they have for deposit or that they want to borrow are too small to make it worthwhile to spend the time and money to travel to the nearest bank branch or other facility. The current system must expand much more rapidly than it has expanded in the past few years to provide ready access to depositors and borrower of micro-amounts. BRI has found plenty of demand for its deposit facilities and for loans at market interest rates and with firm repayment requirements. Its repayment record for micro-loans is superb, so there is no need for any subsidies to interest rates or for special provisions to write off loans. What is **needed is to expand the number of facilities so depositors and borrowers do not have to travel any distance to reach them.** This does not necessarily mean regular branches. Often a once-a-week visit by a bank teller will suffice, to collect deposits and pay loans in a rented office.

A minor step to meet this need would be to encourage BRI to hire more staff for its micro- and small-loan activities. As part of BRI reorganization in connection with re-capitalization, limits were put on hiring, which should be lifted for its highly profitable micro- and small enterprise divisions. BRI currently adds about 100 sub-branches/ unit desa a year. With no constraints on hiring they could double that, increasing their micro lending by 10% a year instead of the current increase of 5%.

More important would be for government to provide a **one-time subsidy for the start-up costs of any financial institution setting up new facilities in areas without service.** This would cover most of the costs for training, purchase of a motorcycle and minimal other equipment, possibly a computer<sup>2</sup>. It could also help cover the additional operating costs as new personnel produce less income than they cost. The justification for such a subsidy is:

- micro-lending has major non-economic benefits in reducing poverty, developing regions with low population density and reducing migration to the cities, which has social and economic costs;
- a start-up subsidy is far less costly and creates fewer distortions in the economy than traditional subsidies through below-market interest rates or debt write-offs;
- it would signal to financial institutions, including BRI management, the importance that the Government attaches to the expansion of the micro-credit system.

The aim would be to encourage new institutions to enter the micro-lending [and deposit] field and existing ones to expand. As a result BRI and others should be lending to less credit-worthy borrowers. Some new borrowers would be helped to build a credit record that makes further

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<sup>2</sup> The total subsidy would be on the order of US\$ 5-7,000 per new unit

borrowing easier in the future. BRI is likely to be the principal beneficiary of such a subsidy, but the local rural banks [BPR –Bank Perkreditan Rakyat] also do micro-lending and some take small deposits as well<sup>3</sup>. More recently BNI, one of the large State-owned banks, has also expanded its activities in this field. The subsidy would be available to any financial institution that is willing to provide both deposit and lending facilities in areas now without them and with a good track record. A good track record could be defined as:

- market interest rates/ no interest rate subsidy;
- NPL [Non-Performing Loan] rates below 5% or 7%.

It would be possible to further increase micro-lending by directing the State and IBRA banks, which are now the principal providers of micro- and small-firm credit [especially BRI], to increase the priority they give to the small loans, rather than the more glamorous and easier lending to the corporate sector. This would call for instructing them:

- to report profit separately for their micro-credit, small-enterprise and corporate enterprise divisions;
- to set a goal of profit maximization and
- to develop and use a system of internal incentives [e.g. bonuses] to reward profitability.

Any system that focuses on profitability favors the smaller loans: micro-credit has been the most profitable and small-scale lending has been more profitable than corporate loans. The principal reason is that the default rate is lowest for the smallest loans<sup>4</sup>. To encourage more and more efficient lending to micro- and small enterprises BRI needs to return to the system of awarding bonuses based on the return on loans made rather than based on recommendations by supervisors, which tend to be based on egalitarian rather than incentive notions.

Another step in expanding sustainable micro-credit is to bring micro-credit institutions under banking rules and supervision if they take deposits or otherwise are funded by the public. The aim would be to greatly reduce the risk of scams, default or other diversion of funds, which would also create problems for borrowers. There is another risk. Micro-credit is very popular right now not only with NGO and government departments, but also with donors. Both the ADB and the German government's aid program [through GTZ] are considering launching micro-credit programs. Competition is all to the good as long as donors do not provide subsidized interest rates or other long-term subsidies which could threaten the sustainability of existing programs of BRI or the more successful local financial institutions.

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<sup>3</sup> BPR could play an important role in micro- and small-scale credit and some do. But they are not really carefully supervised and some lend to owners of the banks. Others do not lend at all, because they are bankrupt. Village credit institutions [Bank Kredit Desa or BKD] exist in Java and Madura and have considerable potential since there are 4,518 of them. Making BPR and BKD into effective, self-sustaining units is a longer-term matter and not addressed here.

There are dozens of niche or specialized micro-credit efforts such as the P4K program supported by the ADB and a program of the Ministry of Agriculture supported by IFAD. They have various rules, borrower groups and interest rates. In addition there are a large number of NGO that provide micro-credit, such as Bina Swadaya which is nation-wide. Analyzing the effectiveness, cost and possible expansion of all these credit efforts would also have taken this project too far afield.

<sup>4</sup> Less than 1% of BRI micro-loans are overdue more than 6 months. During the Crisis 41% of small loans at BRI went bad, while 85% of Corporate loans were in default.

Beneficiaries of financing facilities in rural areas now without them would include agriculture [and fisheries], as well as non-agricultural micro-enterprises. Farmers need banking facilities for extra cash at harvest time and they need to borrow for buying livestock, stocking ponds, minor irrigation and drainage works and so on. But lending to agriculture will not expand by much until counterproductive policies by governments are reduced or ended [see section 4 b below]. So loans to agriculture will mostly flow through its suppliers or customers [see section 8 c].

## 2. Expanding credit for small & medium enterprises

Much of the discussion of the need for expanding credit has been concerned with SME-, rather than micro-loans, for borrowers who can afford the time and cost to travel to the nearest bank branch. There are very few areas of the country where the nearest financial institution is too far away for those borrowing more than Rp. 1 million. In a few more areas there is no competition. In those areas it would be desirable to foster second financial institutions so that depositors and borrowers do not face a monopoly.

Much of the discussion of SME credit overlooks the remarkable expansion in the willingness, indeed the eagerness, of financial institutions to lend to smaller borrowers. During the Crisis banks and others discovered that the smaller borrowers were far better credit risks, better at servicing their loans, than the larger borrowers. As a result there is increasing competition for small, credit-worthy borrowers among BRI, other State-owned or IBRA banks such as BNI and Bank Danamon, and some rapidly expanding private institutions such as Bank NISP and Bank Mestika. This recent radical change in attitudes has greatly reduced the need for a special major effort to increase lending to smaller borrowers. But there still is a need to provide credit to those who are not regarded as prime borrowers. Virtually all loans to SME at present are made on the basis of collateral, with a very conservative valuation of that collateral. That makes it difficult to borrow for rapidly growing enterprises, or enterprises that do not own buildings or other assets readily accepted as collateral. It also gives an advantage to businesses with multiple enterprises. They can borrow against the assets of well-established units to finance new units who lack collateral.

To encourage financial institutions to develop lending to sound SME enterprises with little conventional collateral it is proposed that Government finance a **subsidy program for effective financial institutions that want to develop unconventional loan programs. The subsidy would only be for start-up costs** [e.g. the cost of training; of specialized units; of new locations] **and only for institutions that charge market interest rates and whose NPL [Non-Performing Loan] rates are below 5-7%.** Financial institutions would be invited to submit proposals and the best proposals would receive the subsidy. The financial institutions would bear all of the risk of the loans. The subsidy would be a one-time affair, spread over 3-5 years. The subsidy would be available:

- to establish branches or other facilities in towns/ areas where there is only one deposit-taking and lending institution;
- to develop programs for loans without physical collateral, but on the basis of established cash-flow or other records of performance;
- for programs that target the poorest 20% rather than the somewhat higher income groups among the poor;
- to develop lending on the basis of personal guarantees, again without collateral;

- for programs of medium and long-term lending [e.g. more than one year];
- for fixed, rather than working capital.

Another step to increase lending to SME would be to end the rule that all collateral has to be revalued every 6 months or its value will be reduced. This is more of a burden on small loans since the cost of revaluing collateral is a higher proportion of the income from a small than for a larger loan. If other reasonable rules are in place – such as severe restrictions on lending to the owners or officers of a bank - then government can leave it to the financial institutions to decide how often they need to revalue the collateral.

For an SME credit program to be successful it is important that it makes provision for borrowers to move from “small” to “medium” and then to “large”. For a financial institution to be eligible for subsidies for lending to small firms loans should be limited to, say, Rp. 100 million [\$11,000]. However, it is obviously desirable for some of the borrowers to grow to where they need larger loans. There should be no bar to the same bank continuing to lend to the same firm even if the loans become much larger. The borrower would just move from the “small” to the unsubsidized “corporate” lending department, for instance.

### 3. Venture capital for SME

Some firms need not loans but equity to enter new fields or to grow. To provide venture capital is more difficult than to provide loans, since it requires appraising the prospects of a firm at an earlier stage of development and with higher risk. Inherent in venture investment is the expectation that the majority of ventures will not be successful and that a few highly successful firms pay for the losers. To **provide access to venture capital for smaller firms Government should invite one or more well established and successful venture capital firms to operate in Indonesia. They would risk their own capital, but Government would share the risk on investments in smaller firms.** This approach has been used in Korea, which invited a foreign venture capital firm. The Indonesian government would be a minority investor. Like all other investors it would share the gains and losses in proportion to its share of the investment. While this approach can be useful for firms of all sizes, a fund that focuses on SME can strengthen that sector. For social and political reasons any fund with government investment would be prohibited from using these funds for investment in conglomerates. It would largely help medium-sized firms to become large and new entrepreneurs to join those that grew by virtue of connections [KKN] in the 25 years ending with the Crisis.

### 4. Ending subsidies and rules that undermine the viability of the credit system

The subsidies recommended above will strengthen and expand the existing credit system for MSME. But there are some **subsidies that undermine the credit system:**

#### a. Interest rate subsidies

Currently there is excess demand for loans from private banks that charge market interest rates and insist on repayment. This is clear evidence that such borrowing is profitable for both borrower and lender with no subsidy. For the borrower the alternative usually is the moneylender, who charges far higher rates. It is well known that if government agencies provide substantial interest rate subsidies it has undesirable consequences:

[i] Loan officers often extort some of the difference between the market and subsidized rates;

- [ii] Loans are not made to the best borrowers but to those paying the highest bribes or with the most political influence;
- [iii] Well-connected individuals will borrow at the subsidized rate and relend at market rates;
- [iv] The cost of subsidies, if large enough, can ultimately mean that the system becomes unviable as it expands. The burden on the government ultimately becomes too large. The one-time only subsidy recommended is far easier to fund than a subsidy that continues indefinitely.

Most loan programs run by government departments and agencies have generally involved interest rate subsidies and a high rate of NPL [non-performing loans]. For both reasons they are not sustainable and undermine the viability of the major loan programs that operate at market interest rates and with negligible NPL rates. Terminating these programs as soon as possible will result in substantial savings, especially since some of these subsidized programs are quite large.

#### **b. Loan write-offs**

The main problem with write-offs is that it “rewards the guilty and punishes the innocent”: those who have fully repaid their loans, including interest and any penalties, get no benefits while those who have paid nothing get the maximum benefit. The so-called “moral hazard” is very high: write-offs encourage borrowers not to pay. The longer they delay in repaying or in paying interest or penalty the greater the chances that some of their debt is written off. If, in addition, there is rapid inflation, it means a rapid decline in the cost of repaying the portion that is not written off. The uncooperative borrower benefits double and those who have played by the rules have learned the lesson not to pay in the future. Write-offs or “haircuts” therefore undermine a credit system which can function only if loans are repaid and the funds are available to be borrowed again.

An argument can be made for an exceptional write-off for loans that were not serviced during the Crisis. The main justification is that a large number of otherwise perfectly viable SME were unable to service their loans because of the general deterioration of the economy. If part of the loan is written off, it is argued, these enterprises could again produce, grow and hire more workers. There is also a fairness argument: large enterprises and especially most of the conglomerates and banks had their loans written off at least in part. Why should smaller firms not get the same help? Finally it is argued that a widespread write-off would help the banking system to function again. Critics of the argument in favor of a write-off include some bankers. They strongly believe that the discussion of a large write-off [say 50% of principal, plus all accumulated interest and penalties] is already encouraging their borrowers to delay repayment.

The issue is of some importance since the face value of loans classified as having been made to SME is Rp. 60 trillion [over US\$ 6 billion], a very large sum. This estimate is based on the proposal that all loans with a face value of Rp. 5 billion or less [a bit more than US\$ 500,000] be considered “SME loans”. This is a rather generous definition of SME. First, it does not distinguish between consumer loans and true SME loans. Second, the size of loan is far larger than has previously been accepted as falling in the SME category. In the past, loans of up to Rp.50-100 million have generally been considered as “small” loans, while those of Rp. 50-500 million have been classified as being for medium-scale enterprises. The proposed definition is therefore 10-fold the most generous definition of medium-scale previously used. When the proposal is criticized as overly generous it is defended by a seemingly plausible argument: when

IBRA sold packages of loans to banks and other institutions it received only 30% of face value. Why not give comparable benefits to the borrowers, advocates ask? Even a “haircut” of 50% is a better deal than selling off the loans at 30% or less. The reasoning, however, is faulty. If a bank buys a package of bad loans it expects that some will be totally unrecoverable: the business exists no more, the borrower has left the country or cannot be found or there are no recoverable assets. Other loans will yield a return of only 10-20% of face value, because the recoverable assets have depreciated greatly. These losses will be balanced by some loans that, with some effort, can be recovered totally, at 100% of face value and by others where 50% or more of face value can be recovered. For the purchase of bad loans to be worthwhile:

- the *average* recovery must be high enough so the purchaser can recover what they have paid IBRA, plus
- the costs of collecting the loans, plus
- a premium for the risk that too many loans will be worthless,
- the interest cost for the time between paying IBRA for the loan package and the time when the last payments are collected from the borrower,
- plus a profit.

If a haircut of 50% is imposed, no borrower will pay more than 50%, even if a persistent holder of the debt might have recovered 100%. But the recovery on the worst loans will still be zero and there will be others where the recovery is between zero and 50%. The average recovered may well be less than 30% after taking account of the cost of collecting and the further delay while IBRA waits to see how many borrowers pay off their loans with a 50% concession. And there is the risk that many defaulting borrowers will draw a natural conclusion from the fact that those who paid back at 75% of face value made a mistake – if they paid nothing they would be allowed to discharge their debt at 50% of face value and they would have had an interest-free loan in the meantime. Why not refuse to take 50% and hope that 60% or 65% would be offered later. And they would be saving interest charges of 20% or more on new borrowing in the meantime<sup>5</sup>. If average recovery fell by 10% as a result of the proposed write-off the loss to IBRA and the taxpayer would be a substantial Rp. 6 trillion [over US\$ 600 million].

To minimize the damage to the system it would be important to limit any write off:

[i] to productive enterprises. That is, housing and consumer loans should not be written off, beyond the 25% of face value, plus interest and penalties, a concession available for some time. Banks that bought a bundle of so-called SME loans from IBRA have found that a very large proportion was not for productive enterprises/SME but for the purchase of houses and cars and other consumer needs, such as weddings, often by middle-class or wealthy borrowers. Writing off such consumer loans cannot be justified by benefits in greater production or employment. Write-offs therefore should be limited to loans made to enterprises. Consumer loans should be sold off to private institutions for collection.

[ii] The general write-off for actual SME should not be very much more generous than what has been available in order not to reward those who held out. The past write off was for 25% of principal and all interest/penalties. A write-off of 1/3 of principal plus accumulated interest and penalties would not provide an excessive reward to those who failed to settle earlier.

[iii] To make it more attractive repayment could be stretched over 18 months or even 2 years in monthly installments, with 1/3 due at inception.

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<sup>5</sup> Several exporters were quite frank: we are financing our working capital by not paying back our bank loans. Not paying is like an interest-free loan of course.

**c. A quota on lending to SME?**

A draft bill on credit for SME would require that 40% of all commercial bank loans be made to SME. Such loan quotas have been used before. But they are a mistake. Some financial institutions have specialized in micro-finance, most notably BRI, and some in finance for small enterprises, including both large IBRA or State-owned banks and some smaller private banks. They have become good at it, are very profitable and are expanding this aspect of their business rapidly in order to increase their profits. A small subsidy program and other steps have been suggested to help them expand even more quickly. But other banks have concentrated on “corporate lending” to large firms. If the latter are forced to lend to small firms they will do it badly because they have no expertise in it. They will make bad loans that will quickly be non-performing. At the same time they will be forced to curtail their lending to large firms since they will not have the resources to do both well. The whole system will be less efficient – the last thing Indonesia needs when its financial system is already struggling and unable to provide the credit the economy needs.

**d. Financing subsidies: Ending counterproductive subsidies and raising fees**

To fund the subsidies suggested [in items 1-3 above], designed to extend the successful loan programs and to innovate, one can use the savings realized from abolishing loan programs operated by a large number of government agencies and departments. Further savings will be realized from limiting the loan write-offs, as suggested above [item 4]. Finally additional revenue can be realized from an increased charge for the credit guarantee program for banks. That fee is now too low for a variety of reasons and increasing it has long been advocated as part of a banking reform package. Most of the additional income realized is not needed to back up the guarantees, since will rarely, if ever, be used. The additional fee income could therefore be largely or wholly used to fund the proposed subsidies.

**5. Reducing controls, regulations, taxes and fees on internal trade**

A major complaint, and in many cases THE major complaint of SME has been that governments make it difficult and costly for firms to set up in the first place and to operate thereafter. Many SME consider government-created obstacles a more serious problem than lack of credit. For instance, to get permission to set up a firm in most kabupaten requires visiting 6 to 15 or more offices, with delay and both official and unofficial payments at each. Expanding a business is equally complicated, time-consuming and costly. Finally there are controls and regulations with respect to exports of goods outside the area and outside the country. Notorious cases include the regulation of cattle exports from the Eastern islands to the rest of Indonesia and of rice exports from rice surplus to deficit areas. All enterprises have problems with excessive regulation and corruption. But the problems are especially serious for smaller firms. In a small firm usually the entrepreneur/ owner has to personally visit each office, while in a large firm a lawyer, accountant or “fixer” can be given the task. In a small firm the owner is not a specialist in the paperwork required, while in a large firm a specialist can be hired, familiar with dealing with a particular government office and its paper-work. The standard “unofficial” payment is a tiny part of the cost of doing business in a large firm, but in a small firm even the cost of getting in the door may be a big burden. Large firms have connections; small firms rarely do.

Another problem is posed by the imposition of fees and taxes, especially on trade. Decentralization has generally aggravated the problem. As local governments have gained



power and responsibility for providing services they have found themselves in great need of revenue and increased power to extract it from business. The wealthy kabupaten do not have serious problems. But the majority are not wealthy and find that the resources transferred to them are inadequate to cover the operating expenses of a government with increased responsibilities, plus the patronage needs of new leaders, plus development and service needs. Moreover most sources of potential revenue are not under their control. Only aspects of the property tax are under their control. Rates for nearly all taxes are set centrally. Often the easiest way to raise additional revenues is to tax trade into and out of the city, district, sub-district or Province. This increases costs and causes delays for all businesses, but again the problem is most severe for small business. They do not have the contacts, the funds or the people to help them get around this problem reasonably quickly and cheaply. In short, **the problems created by controls, regulations, taxes and fees on business are especially difficult for smaller firms.** In interviews many firms say that the cost of corruption has increased as the number of those with influence on decisions has increased.

#### **a. Financial incentives to reduce controls and regulations, especially on SME**

The National government can support and encourage reducing the controls and regulations that particularly hamper SME by providing a significant subsidy to local governments that reduce or eliminate controls. As a first step a subsidy, say of Rp. 1 billion, can be provided to any Kabupaten which provides “one-stop service” for establishing or expanding a business. The subsidy could be provided the moment all of the permits are issued in the same room, as they now are in a few Kabupaten [e.g. Deli Serdang in North Sumatra]. Once a Kabupaten has accomplished that step a similar subsidy could be provided when all permits require only a single form and submission to a single official [in some “one-stop” offices each of the agencies involved has its own desk and its own procedure; they are only located in the same room].

A similar subsidy scheme would be used to encourage the elimination of particular controls or regulations. The first step would be the elimination of regulations by the national government. For instance, establishing a new business should be a reporting matter, not a permit matter, and should be valid for all activities of the business. A new firm would just hand in a report on what it planned to do and where, together with any needed information on ownership and related matters. It would then be issued a registration number but would not require any permission. The registration would be good for all activities of the firm and no separate forms would be required for production, sales, imports and exports. The registration number would also be the tax number. In some countries small firms can be established and registered by mail, but if that were too radical a step for now then a simplified, one-step process would still be a major reform. Once national procedures have been simplified, subsidies can provide incentives for Provincial and local governments to adopt simplified procedures as well.

#### **b. Prohibiting interference with trade: a Constitutional amendment**

As already noted, decentralization has greatly increased the incentive for interfering with and taxing trade and the possibility of doing so. Decentralization laws contain clauses to prohibit taxes on trade, but these can be evaded, especially by the use of fees or the requirement to pay for permits, some ostensibly imposed for health reasons. Surplus Districts and Provinces can also impose controls over exports in order to lower prices for consumers in the area and controls over imports can protect producers against competition. Nations with decentralized powers,

including federal states, all have had to deal with the danger to an integrated, efficient economy posed by taxes, fees and controls imposed by sub-national units. Many federal states have dealt with this danger by a Constitutional provision that prohibits any such interference with trade within the country<sup>6</sup>. Firm steps to prevent obstacles to internal trade are especially important in Indonesia since the danger of obstacles to trade is especially great and the benefits of a large market is especially important – it is one of the major advantages of the country over others in Southeast Asia, countries that are under less pressure to create jobs. As also mentioned, obstacles to internal trade are especially serious for smaller firms who have the least influence to overcome them and for whom the financial burden is especially great, because they cannot spread the costs over a large turnover. **The best way of dealing with the great danger of obstacles to trade within Indonesia is a Constitutional amendment that prohibits any District or Province from imposing controls, taxes or fees on internal trade.**

## **6. Technical assistance [TA] and business services**

Another major handicap for smaller firms is the problem in accessing technology and business services and finding employees with the needed technical knowledge. Larger firms can hire specialists, if need be foreigners, to perform specialized services: accounting, marketing – especially to foreign markets, information technology, installation of new machinery, keeping up with technical developments, technical training, etc. Smaller firms do not have the sales volume to support specialists. Only if the specialists serve many small businesses in the same area can small firms benefit from economies of scale. One of the difficult problems in the more rapid development of SME is how to provide the TA and business services they need.

### **a. Government has generally failed to provide services efficiently**

One obvious solution is to have government provide TA and business services to groups of SME. But experience has shown, and interviews of SME have confirmed, that governments do a poor job of providing services to SME. Governments as institutions and government officials are just not flexible enough to adjust to constantly evolving technology and information. The information or training they provide is often outdated. Hours tend to be rigid while businesses need highly flexible hours. Governments also find it difficult to pay the very high wages which some specialists command or which may be necessary to get people to work long hours. There are a few exceptions, but reports from SME quite consistently indicate that they have not been satisfied with the services governments provide. And since these government efforts are not self-supporting there is no market pressure for improvement. A major exception to the generally unsatisfactory provision of services by government agencies is the provision of statistics: governments are good at providing information on where firms in particular industries are locating, which activities are growing, to which countries exports are going and so on. Providing data more quickly and making it more widely available is an important service government can perform.

While their record of training qualified personnel is not good, government technical training institutes are among the few organizations that have the equipment needed for training and a technically skilled staff, able to impart knowledge of relevant machinery. If they can be

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<sup>6</sup> The United States does not have an explicit provision in its Constitution. But the problem was dealt with successfully by a Supreme Court interpretation of the “Commerce Clause” in the Constitution that has effectively barred any interference with or levies on internal trade.

reorganized so that part of their budget needs to be earned by providing services for a fee to private firms and groups of private firms they would have a strong incentive to provide relevant and satisfactory training at times convenient to business.

#### **b. Subsidies and support to private business services**

Where private firms supply technical and business services there is the usual market test: if the services they supply for a fee are not satisfactory they will not survive. The problem is to overcome the hurdle of start-up costs and economies of scale. Small firms that need technical assistance and business services are usually reluctant to buy them because they do not want to risk the cost of unsatisfactory services. They also find that there are not the specialized technical services they need if there are not other SME in the same industry established in the same area. Suppliers of services are reluctant to set up in an area where there is not a concentration of small businesses in the same industry because they do not know if there will be enough effective demand for them to survive and make a profit. Large firms have enough demand for specialized services to hire them for their own needs: a large batik firm can hire a designer familiar with the demands of consumers in Germany or Australia; small firms can not afford that. To overcome start-up and information costs for smaller firms there is justification for temporary subsidies.

A Swiss institution [SwissConsult], funded by the Swiss government, has operated a small but successful subsidy program to develop private business support services. It has just begun to expand as it generalizes from its successful experience in East Java. Unfortunately the Swiss aid program for Indonesia is coming to an end - Indonesia is not considered among the world's poorest countries – just as expansion seems feasible. **It would be useful to find alternative sources of funding to continue and expand the small successful program to develop private business support services for SME.** As of now there are only 9 Business Development Centers, so it would also be important to search for and experiment with alternative ways of providing these services.

One way would be encourage the private business arms of the World Bank and the ADB to invest in programs to supply business services, particularly to smaller firms, in some areas of the country. They could use NGO, government institutions or existing private organizations as implementing agencies. The Japanese government may also be willing to support technical services for particular industry groups. Because the supply of business services to small firms is management intensive and may require an initial subsidy it would be a mistake to have a single design for a nation-wide program. Experimentation with different approaches, and expanding those that work is likely to be a better approach.

It is much easier to provide business support services if SME firms in the same industry cluster together. Such clustering occurs naturally because of “external economies”. That is, in an area where there are already many furniture factories a new factory will be easier to establish because it can find experienced skilled labor, furniture designers, marketing organizations and wood suppliers. Once clusters are well established their location becomes well known. But information is not readily available on clusters that are just beginning to develop<sup>7</sup>. However, BPS is now publishing information on small and household firms on an annual basis [SUSI] and

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<sup>7</sup> The furniture industry of Jepara is by now very well-known. It came as a complete surprise that another furniture industry cluster seems to be developing in Pasaruen.

has been processing information on medium and large firms more rapidly than in the past. Neither survey is now processed to identify emerging industry clusters. A dynamic analysis of existing surveys by industry and location could quickly identify where industry clusters are emerging. A small expenditure of funds would allow existing surveys to be processed to **more quickly identify emerging industry clusters and to publicize this information** to firms that provide technical assistance and business services to particular industries.

#### **c. TA and services through suppliers, customers, Trading Houses**

Historically in other countries and currently in Indonesia many SME get much of their technical information from machinery suppliers and market information from the buyers of their products, especially if they buy from or sell to foreign firms. These foreign sources of information have been adversely affected by the increased risk and uncertainty of operating in Indonesia. Many of these foreign firms continue to perceive Indonesia as a risky environment where debts cannot be collected, communal and other strife can halt production, changeable government policies can turn profitable into losing enterprises and foreigners are not secure. They are therefore reluctant to extend credit, place many orders or even to come to Indonesia. Again small firms are most affected since they can less afford to have their own purchasing and sales office abroad or to invite foreign buyers. Of course the most important contribution that government can make to a solution of this problem is to improve the general business environment and the security situation, but that has already been discussed in the introduction to this paper.

In other countries Trading Houses have played a useful and important role in providing economies of scale to smaller enterprises by importing and exporting in large quantities and then supplying firms and buying from them in smaller quantities. Government has discouraged foreign Trading Houses from operating in Indonesia. But to help SME Government should instead encourage Trading Houses to set up and to expand. Larger firms can handle their own exports and imports, but smaller firms would benefit from the services such institutions can provide them, including export financing, knowledge of foreign markets, quality assurance to foreign buyers, trading channels and experience in dealing with customs, regulations and tariffs.

#### **d. The importance of organizations of smaller firms**

There has been a remarkable development in the last 2-3 years of organizations representing smaller firms, aided by the Asia Foundation and others. In many cities there are Forda, or Forum Daerah, which bring together smaller firms for the exchange of information, for lobbying on behalf of small firms and for joint activities [e.g. training]. In a few places there are, in addition, NGO [e.g. Pupuk in East Java, BITRA in North Sumatra] some of which provide information, or credit or advocacy services for small enterprises. While both Forda and NGO supporting SME are in their infancy they have a great potential in the development of small firms:

- they provide an authentic voice for SME in dealing with government policy and with aid programs, a counterweight for the experts and officials that have in the past spoken for the SME, often with limited knowledge;
- for the first time they provide a forum for SME to exchange information on technology, business services, marketing and government actions, increasing the knowledge of members and spreading best practices;
- they can help organize, attract and negotiate for shared services for members;

- they can serve as a conduit for government and banking services, helping to overcome the problem of reaching tens of thousands of small firms.

Forda appear to be truly organized and run by the enterprises and to represent the interests of the small firms, rather than being quasi-governmental bodies, run and dominated by government officials. They clearly pursue the interests of members.

But if they are to realize their potential they need to expand in coverage and in their ability to deliver services. As they expand in size separate bodies, or sub-units, for different industries would be helpful to deal with the specialized needs of particular industries. In allocating aid government should give high priority to programs helping these organizations to develop. So far their principal support has come from the Asia Foundation, using funds primarily provided by USAID. Since the Asia Foundation has extensive experience in the field it would be important for support from USAID to continue.

## **7. Inadequate infrastructure**

The general consensus is that the infrastructure has substantially deteriorated since the beginning of the Crisis and this is confirmed by field trips. Roads and ports have been among the more seriously affected. The power supply is now the most serious problem in some areas of the country. Unless urgent action is taken power is expected to be almost universally in short supply in a few years. The problem with phone service is not so much deterioration as that the system is inadequate for commercial Internet use. Broadband services are largely limited to the Jakarta area and even there are available only in some locations.

Small businesses suffer especially from inadequate infrastructure. A large firm can buy an efficient generating set, a small one cannot. A large firm can pay for heavy-duty trucks to service it. It can pave its own access road and set up a water-purification plant. It can even set up a purchase and sales outlet in Jakarta with broadband access to the Internet. A large firm can also afford to run a remedial training program, teaching its employees knowledge and skills they did not learn in the formal school system as well as specialized training needed by the firm. A small firm cannot afford any of these. Special access for smaller firms to parts of industrial parks/ industrial estates set aside for them would help. But ultimately the solution lies in improved infrastructure for everyone.

One step in that direction is the expansion and reorientation of the KDP/PPK and UPP/P3PK programs discussed below. An important second step would be to use special matching budget grants from the National government to foster the use of Districts' own resources for infrastructure investment instead of current operating costs. Hiring more government officials, or patronage, is the most attractive use of resources available to the Provinces and Kabupaten from a short-term political perspective. But for the country to develop it is important that adequate resources be available to maintain and develop the infrastructure. The National government can foster that, especially in the poorer Districts, by offering to match any funds spent by them on infrastructure, including maintenance, as distinct from operating costs.

Improving telephone service, especially outside the Java/Bali area is an urgent need. Many small businesses have only one telephone because of access problems and cost. They therefore cannot benefit from the great advantages email and the Internet provide in finding inexpensive suppliers,

potential customers and technical assistance. Email also can facilitate communicating with other businesses. With one telephone and great noise on the lines these benefits are not readily available. Again large businesses can afford dedicated lines. A higher proportion of large than small firms is located within reach of a fiber optic cable [basically in the Jakarta area] with all the benefits it brings.

Small business has boomed in Bali in substantial part because tourism brings with it an excellent infrastructure, often one with lower costs thanks to economies of scale. If tourism can be developed elsewhere – for instance in the Yogyakarta area, around Lake Toba and Toraja, in Lombok – a major side benefit will be not only better telecommunications, but also better roads and air services. Tourism obviously will flourish only if personal security is assured and private investors are willing to develop the first class hotels and other services tourists demand.

Even more important is to improve services and lower prices by introducing competition. It is startling how good wireless/cell phone/ hand-phone service is in Indonesia compared to wired/ landline telephones. The former has been competitive virtually from the beginning; the latter has been a government monopoly, not under any pressure to improve performance. It is not simple to reap the benefits of competition in developing a natural monopoly like telephones. But there is now extensive experience with it in other countries that Indonesia can draw on to shape its own program.

### **8. Higher minimum wage not a problem for small firms**

The rapid increase in the minimum wage in the last two years has raised the real wage in manufacturing, the wage adjusted for inflation, to a level above where it was before the Crisis. The resulting increase in the cost of unskilled workers might be expected to affect even smaller firms with more than 10 workers. But of a handful of entrepreneurs who were interviewed none considered it a serious problem. They dealt with it by:

- hiring casual workers who are not covered;
- asking workers to work extra hours to make up the higher per day cost;
- raising the skill requirements so they could afford the higher wages;
- using piece work to avoid the issue;
- forming separate companies so that each was below the number of workers where the minimum wage applies.

### **9. The special needs of agriculture**

Agriculture is by far the largest employer of unskilled and semi-skilled labor and the largest “employer of last resort,” the principal sector which absorbs workers who enter the labor force but cannot find employment elsewhere or who have lost their jobs in other sectors. At the height of the Crisis agriculture performed this function by absorbing an additional 5 million workers. But until the Crisis, when the economy was growing rapidly, it was actually shedding labor, in a pattern typical of countries that have achieved reasonable growth. **How many productive jobs agriculture creates, as distinct from how many workers it is forced to absorb at low and declining productivity, has a profound effect on poverty alleviation.** Despite agriculture’s importance most of the policies and programs that affect it are not discussed in this paper, because there is a whole team addressing agricultural policy issues. The discussion here is

limited to a brief discussion of a few issues that affect SME as well or that arose in the course of the work underlying this paper.

**a. The possibility of more rapid mechanization and its effects**

In some areas of East Java and North Sumatra mechanical planters have been introduced. If this becomes widespread it would greatly reduce labor needs in rice agriculture, since traditional methods of planting and transplanting remain one of the most labor-intensive aspects of the process. There appears to be substantial underemployed labor in agriculture already. That is, there are many workers whose transfer to other occupations would not significantly reduce output in agriculture. Accelerated mechanization, by displacing more workers, could therefore simply add to the number of workers who are underemployed, who crowd into activities where there are already enough workers. In that case mechanization may be profitable for the individual farmer who substitutes machinery for labor, but not for the economy as a whole, since it does not increase output elsewhere. That would provide an economic justification<sup>8</sup> for subsidizing the use of unskilled labor, if it were not for the fact that any attempt to do so would be an administrative and enforcement nightmare and not a realistic proposition.

But even if subsidizing unskilled labor in agriculture is not feasible the likelihood that it would be desirable makes it **essential to be sure that mechanization is not being subsidized** by interest rates that are below market, by the use of aid funds to import agricultural machinery or by other measures. Any subsidy for agricultural machinery should be eliminated, unless it can be shown that mechanization reduces costs even if labor is valued at its true [social] cost, not at market prices. Since it is the relative cost of labor and machinery which matters in the decision whether to substitute machinery for labor, one can affect this ratio either by making labor cheaper or by making machinery more expensive. Since subsidizing labor in agriculture is not administratively feasible the alternative is to increase the cost of machinery. A simple tax on each machine at the production or import stage will take care of that. If the tax/tariff is low, as it should be, the cost of policing it will be quite limited.

Before adopting a policy of taxing some agricultural machinery it is necessary to study the economic consequences to determine whether it is justified. But it is worth collecting the necessary information and doing the analysis since it may save hundreds of thousands of jobs at no cost to society. Indeed, if the result is lower costs of producing rice once labor is correctly priced then there are net benefits to society in addition to the employment and workers income generated

**b. Increasing the ability of producers and traders to hold stocks and to reduce price fluctuations**

Both producers and consumers suffer from large seasonal fluctuations in agricultural prices, especially those of rice. The low harvest price discourages investment in increasing output and the high off-season price is a hardship for poor consumers, a large proportion of whose expenditures are on basic foods. It could be argued that if seasonal fluctuations are greater than holding costs traders will find it profitable to store and to export and import the commodity. Over time the fluctuations will be reduced to storage costs, a risk premium and a small profit.

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<sup>8</sup> That is, there would be a difference between the market price of labor and its social cost, or shadow price.

However, for the next few years the market, especially for rice, may not function well. First, for decades the BULOG has intervened in the market and it continues to operate in the rice market. The trade and storage facilities are therefore not well developed. Second, BULOG and government intervention have been erratic and unpredictable. There is great political pressure to keep producer prices high and, lesser pressure, to keep consumer prices low. Traders therefore find it difficult to predict the market and either stay out of it or charge a hefty premium to insure themselves against unanticipated price changes due to government action. Third, transport costs have been high so that even if the price fluctuations in major ports are not excessive, the producers may find that they have to sell at a very low price in their area because they have no capacity to store and then buy back at a far higher price when they need the rice or maize for their own consumption. All of these problems are aggravated by the fact that there is no well-developed system enabling producers to hold output beyond the harvest season, both because of problems with storage and because they need cash urgently to pay off accumulated debts.

These facts make for a strong case for government agencies and banks to help **develop a system of local bonded storage and reliable warehouse receipts, to enable producers and local traders to hold goods for several months under secure conditions and to receive substantial payments up front.** As in other countries, local storage facilities would store crops and issue storage receipts against which the person storing the goods can borrow or which he can sell. BULOG or another quasi-governmental agency would lend the producer a fraction [60-80%] of the expected or the guaranteed price of the produce. If the price then rose above the amount paid, the producer/ trader can sell the storage receipt at a premium and pay off the loan [plus interest of course] and pocket the difference. If the price should drop below where it was at harvest the producer would not pay back the loan and the produce would belong to the lender. If the producer decides not to wait to the off-season he can sell the storage receipt to someone else. The stored commodity would belong to whoever holds the receipt as long as he pays off the loan. The essence of the system is a reliable storage system which keeps the produce safely, with no deterioration and hands it over only to the person who holds a legitimate receipt. This would remedy a major weakness of the present system: the inability of the producer to hold the commodity from the harvest to the lean season, even if it is very profitable to do so. It would also benefit consumers by reducing the seasonal fluctuations.

The government needs to do two things to bring about such a desirable system:

- encourage the setting up of local storage facilities. The existing system of BULOG storage can be the nucleus of the system. Government could offer a small subsidy to BULOG, private operators and cooperatives to build facilities to the appropriate standard.
- establish an agency that supervises the functioning of the system, assuring that warehouse receipts are not forged, that the goods which they represent are not exchanged against lower quality commodities nor sold to unauthorized persons.

### **c. Credit for agriculture**

The expansion of credit for MSME has already been discussed and that discussion applies to agriculture. The extension of micro-credit institutions to new areas, proposed above, will especially benefit the agriculture system, since the underserved areas are virtually all rural, with agriculture and its suppliers and buyers the principal economic activity. There are, however, some aspects of credit for agriculture that warrant special attention:



- agriculture receives less credit from the banking system than it should because of the uncertainty created by government policy. Agriculture has in the past had more loan forgiveness than other sectors, particularly with respect to loans extended through the cooperatives. BRI and other financial institutions are then reluctant to lend since they expect to be paid back with interest but are competing with lenders who are expected *not* to insist on collecting either principal or interest. Moreover BRI and other banks they fear that borrowers will be reluctant to pay back their loans to banks if they see that other borrowers, their neighbors, are forgiven their debts by cooperatives or the government<sup>9</sup>. So the first imperative for government credit programs is the same as for doctors: "Above all, do no harm".
- agriculture functions as an integrated system, with many large farmers also trading in agricultural inputs or products. As a result, much of the credit received by agricultural producers is provided by their fertilizer dealer, by their machinery supplier or, in the case of some commercial crops, by the purchaser of their output. It may be more efficient to extend credit for tens of thousands of traders who on-lend to farmers than directly to millions of farmers, as long as there are enough traders for the credit to be on competitive terms. Traders are often better able than banks to lend on the basis of the reputation of their borrower or the experience they have had with repayment of past loans. The program for SME credit outlined above will therefore benefit agriculture indirectly by increasing the credit to the whole agricultural system.
- the collateral problem is especially serious for agriculture, because land titles are unclear and land is the principal asset that can serve as collateral for agricultural borrowers. If the title is unclear it can make it impossible to obtain loans, or at least limit the size of the loan. It would be a major step in improving the functioning of the credit system if **existing small programs for land titling are be expanded and accelerated**.

**d. Fostering, not hindering, a shift to crops that Indonesia can produce efficiently**

The center of agricultural policy for much of the last 30 years has been the achievement of rice self-sufficiency. For much of a decade Indonesia has been close to or at that level. Large areas produce rice very efficiently and are able to compete at world prices lower than they have been recently. If these areas are helped to increase output per hectare they can supply most of the rice that Indonesia needs. But other areas can produce rice at internationally competitive prices only if the growing of rice is substantially subsidized. Over the last decade or more the trend of world rice prices has been down, especially in real terms, taking inflation into account. Experts expect that trend to continue. Of course, there will be years when output in the major producing countries is hit by bad weather, resulting in higher worldwide prices, but over several decades the trend is expected to be lower prices. For Indonesia to continue to grow rice in areas not well adapted to it would require increasing subsidies, a costly proposition which Indonesia can ill afford. Some modest protection/ subsidies to rice growers are justified to allow them to adjust more slowly to declining relative prices and to shift to other crops. A lower rice price, of course, benefits the great majority of the poor who are net consumers of rice.

But over the long term the poor will also benefit if areas less well adapted to rice are helped to shift to other crops that can be grown competitively without increasing subsidies. Jobs growing these crops have a more secure future, since they do not depend on the willingness of

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<sup>9</sup> ¾ of debt to agricultural credit cooperatives [KUT] are considered bad debts. Government still provides a subsidy of Rp 400 million a year for loans to new agricultural credit institutions.

government to fund increasing subsidies. Some of these crops will also generate more jobs in processing and handling.

Some economists argue against all subsidies to agriculture. They acknowledge that most developed countries provide substantial subsidies to agriculture, which make their exports cheaper on the world market than they would be if trade were truly free. But they also argue that this is not an argument for Indonesia to provide compensating subsidies for its own agriculture. Indonesia can simply take advantage of importing rice, sugar and other agricultural products at the subsidized, cheaper price, benefiting its consumers and the producers of non-agricultural goods. But this ignores several considerations:

- in a country with substantial underemployment, and the social unrest which it produces, the creation of jobs provides non-economic benefits which are lost, at least in the medium-term, when Indonesia substitutes agricultural imports for domestic agricultural production;
- because there is under-employment, market wages of unskilled workers in agriculture are above the true social cost of labor. This justifies a subsidy to labor to bring the market wage down to the social cost. Since such a subsidy is not administratively feasible a second best solution is to subsidize or protect the goods produced by unskilled labor, most notably agricultural products.
- Indonesia has Dutch disease problems: its currency is overvalued in terms of factor endowments because of the temporary effects of substantial oil and gas exports. Temporary protection to agriculture is justified to prevent its decline during this period, since the decline will be difficult to reverse when the oil/ gas windfall is much smaller as net exports decline.
- the country needs to insulate itself to some degree from politically driven changes in agricultural policy in other countries. Otherwise it will be vulnerable if foreign countries reduce their subsidies, say under WTO pressure.

Arguments along these lines can justify some protection to agriculture. But these are not arguments for protection only for rice and sugar, or other specific commodities, but for some protection to agricultural commodities that Indonesia can produce efficiently and competitively in the medium term. With respect to rice policy, the most important element in Indonesia's agricultural strategy, and the beneficiary of substantial protection and subsidies, a sensible medium term [say, 5 years] goal would be:

- a low and gradually declining level of protection, ranging from 5 to 25%, the level depending on whether the world market price is temporarily low or high;
  - gradual reduction in other specific subsidies for rice producers;
  - greater expenditure on area-specific research and better extension
- with the aim of helping the more efficient and low-cost producers to expand their output and encouraging higher-cost producers to move to products where they will have comparative advantage. High rates of protection do not work, in part because of smuggling, in part because customs officials are bribed to assess a low or zero tariff on part or all of a shipment. A high tariff then may increase the size of the bribe, but not affect the final price by much.

#### **e. The great employment potential of agricultural processing**

Agricultural processing is a sector with great potential to increase both jobs and income of unskilled workers because most of the processes are very labor intensive. Experts familiar with processing industries elsewhere in Southeast Asia think there is substantial scope for further development of canned, frozen and processed fresh fruits, vegetables, flowers and fish. One obstacle is that some crucial inputs are high cost in Indonesia: tin for cans, sugar needed in some

processing and imported packaging materials. Poor infrastructure, especially roads and telecommunications is another. A third obstacle is the absence, except in Bali, of low cost airfreight as a result of tourism<sup>10</sup>. A key obstacle could be overcome if Indonesia adopted on a permanent basis a policy allowing the duty-free import of goods needed by processors who export at least 70% of their output. Issues of infrastructure and tourist development are discussed elsewhere in the paper.

## **B. Expanding and Reorienting the KDP/PPK and UPP/P3KP Programs**

The discussion so far has dealt with the development of Micro-, Small- and Medium Enterprises [MSME], including increasing productivity in agriculture, as a major path to the creation of demand for unskilled labor and the resulting increase in the income of the poor. The discussion turns now to another important approach to poverty alleviation: the labor-intensive programs that are targeted on the poor, especially the Kecamatan Development Program [KDP/PPK] and the Urban Poverty Program [UPP/P3KP].

### **1. Reorienting KDP/PPK to stress infrastructure development, employment and sustainability**

KDP and UPP in one sense are the successors to the INPRES program in providing funding for locally selected and administered programs to develop infrastructure and achieve other aims of the community. However, the current emphasis of both programs is on empowerment of the poor and of the local community, and on improving governance. They have had an excellent record in achieving these aims with small losses to KKN – corruption, collusion and nepotism. While empowerment and good governance are important objectives, the stagnation in the income of the poor elevates the importance of providing additional employment for unskilled workers. Employment and income were the key objectives of the predecessor INPRES program. They are rarely, if ever, mentioned in reports on the KDP and UPP programs and they are not among the criteria for choosing proposals for funding. In fact, estimates by project management are that some 70% of the KDP expenditures for the infrastructure part of the project are for labor. Making employment a specific objective in project selection and design might further increase the direct impact on employment. Currently the creation, improvement and maintenance of infrastructure are also not central objectives. Instead an important feature of KDP is an “open menu”. That is, project selection is entirely a village committee decision, with no restrictions on what can be done. **Greater emphasis in project selection on infrastructure development and maintenance can enhance the direct and indirect effects on employment and improve infrastructure.** As noted above, a deteriorating infrastructure is now an obstacle to the growth of the economy and is particularly serious for Small and Medium Enterprises [SME], the most labor-intensive parts of the economy.

**2. Ending the credit elements in KDP and transferring the funds to development projects. KDP was not well designed to provide credit on a sustainable basis.** The repayment rate has been well below the micro-credit programs of BRI and of the more successful NGO. Indeed there was some ambiguity on the part of borrowers whether repayment was essential. The credit

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<sup>10</sup> Wide-bodied planes bring in not only tourists but also much airfreight to supply tourists with special foods and other supplies. They take out the same tourists but their freight space is largely empty since the goods have been used.

element in KDP has therefore been reduced year after year and is now down to less than a fifth of expenditures. Essentially this is a “pre-credit” program, providing very small sums, primarily for petty trading activities. Some of the recipient families might become eligible for credit if they were successful. With the proposed new focus on infrastructure and employment the credit element can be phased out. Credit activities would be transferred to the expanded micro-credit institutions, discussed earlier, which also provide deposit facilities and which are well designed to collect repayments. Ending the credit element of KDP will free up funds to support the infrastructure development aspects on a long-term basis.

An alternative to ending the credit element is to transfer into BRI the 20,000 or so village accounts that have been established to provide the credit. Future loans would thus come under well-established and effective BRI rules. The loan selection and repayment record should improve. While the KDP was not a good credit program it was very well targeted on the poor. Combining the good targeting of KDP with the good credit administration record of BRI should achieve both purposes.

### **3. The credit element in UPP – a difficult issue**

The Urban Poverty Program [P2KP] also has an infrastructure part and another part that provides credit for private economic activity, but the ratios are almost the reverse of those for KDP: credit is about three-quarters and infrastructure one quarter of the program<sup>11</sup>. So if credit were phased out, very little would be left. Yet UPP credit suffers from some of the same problems as credit under KDP. Repayment rates, while far better than for the cooperatives or for the programs run by government departments, are below the rates for BRI and the better NGO. As a result the program is not sustainable. The local credit bodies mostly run negative cash flows because of loan default and high administrative costs. This contrasts with the record of BRI whose micro-credit program is very profitable. The great bulk of credit is used to expand working capital for petty trading operations. Since traders are not among the poorest most of the credit under UPP does not benefit those defined as poor or near poor. And since only 14% of the borrowers report hiring labor as the result of the credit, the program also does not create much employment.

The management of the program and its major supporter, the World Bank, recognize these problems – indeed the criticisms cited above come from their frank evaluation documents. In Phase II of the UPP, under negotiation in May, they propose tightening up on lending criteria and on repayment rates to improve the record. Yet as the sponsors recognize, the borrowers’ groups have not been effective in dealing with default. And in an evaluation of the credit element of KDP the World Bank recognizes that the success in achieving community empowerment makes it more difficult to achieve loan repayment. It takes a hard-hearted banker to collect loans from poor people. What to do in the urban areas is not clear. Poverty is substantial and is a serious moral, social and political problem. And urban government-administered programs have suffered their share of corruption and mismanagement, so there is much to be said for a program that gives the poor a major say in decisions. So there are strong arguments for an urban poverty program with the poor playing a large role in decisions. But for the UPP to be successful it needs to create jobs for the poor, that is, for unskilled workers. The first step is to discuss with those responsible for the UPP program whether it would be possible to have a shift in emphasis

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<sup>11</sup> There is also a third component: funding community development programs takes about 15% of funds.

for the UPP similar to that advocated for KDP. In the case of UPP there would be several elements to such a shift in emphasis:

- from loans for private activities to support for infrastructure development;
- within the credit program, from loans overwhelmingly for working capital for petty trade to more loans for micro-manufacturing and service establishments more likely to create demand for labor;
- within infrastructure development from construction of markets to facilities for production; in effect industrial estates for micro- and small enterprises.

It is unclear whether this is a feasible and desirable reorientation.

#### **4. From short-term demonstration to permanent development project**

##### **a. Currently: A short-term program to demonstrate the benefits of empowering the poor and of good governance**

KDP was designed to last only 2-3 years in any kecamatan. The idea was to demonstrate the feasibility and the benefits of programs designed and run locally, primarily by the poor. That could be done in 3 years and then the program would move on to other areas. In its first year the KDP began in 500 kecamatan [Sub-Districts], chosen because they were among the poorest in the country. They received full funding of both program and supervision/TA costs from the World Bank. However, after 3 years the program is being terminated, with no further World Bank funding in 450 of these kecamatan [50 of the most successful received a reprieve and are being continued for at least one more year]. Next year the kecamatan that entered the program in the second year will be similarly terminated. The monitoring and technical assistance institutions that have supported the program in particular kecamatan are being dismantled as the program ends and the people who have helped run an efficient and very low-corruption program will largely lose their jobs.

##### **b. Proposed: A permanent program to develop and maintain infrastructure and create jobs**

The Government has supported a schedule of ending the program in each kecamatan after 3 years because KDP was seen as a one-time effort to improve governance and participation in decision-making by the poor and by local groups. In addition it was assumed that after 3 years the values of participation, efficiency and honesty would have enough support so that some programs would continue with local funding. But the “graduating” Sub-Districts remain poor, with a high proportion of poor people and it appears that the programs in the 450 graduating kecamatan are simply coming to an end. But if the focus of KDP shift to improving infrastructure and raising the income of the poor by creating employment then it should become a long-term, indeed a permanent, effort. It is therefore **proposed that KDP continue to support kecamatan that have been in the program for 3 years.** Initially the support would be for another three years, but the aim would be a permanent program for kecamatan-level infrastructure development. The KDP would then be a successor to the INPRES program, but at the kecamatan level, in fostering the creation and maintenance of local infrastructure and creating productive jobs both directly, in the construction and maintenance of infrastructure, and indirectly by supporting productive investments, especially by MSME. Of course, if KDP continues to include kecamatan now expected to “graduate” that would mean an expansion of the program which will require additional funds.

A similar long-term perspective should be adopted for UPP. It also needs to be extended to eligible urban areas in the whole country. Currently Sumatra and NTT are not covered. Even Phase II, starting soon, will not cover cities in Sumatra. Because urban poverty is a serious problem, it would make good sense to extend the program, or a similar one, to Sumatra and NTT, with financial support either from the ADB, or if that is not feasible, by expanding World Bank support to the rest of the country. But without further work it is not possible to be certain how the program needs to be modified to focus on employment and infrastructure development.

**c. The importance of integrating the programs with local governments while retaining the role of the poor and of transparency**

To assure a major role for the poor and maximum transparency and to minimize diversion of funds the design of both programs essentially bypassed local governments. A new structure was created, reaching from the national office in the Interior Ministry in Jakarta all the way to local committees in villages or urban wards. These committees were designed to be dominated by the poor and to have a strong representation of women. This was a workable arrangement for a short-term temporary program, entirely financed from the outside and whose principal objectives were the empowerment of the poor and good governance. But it is not a workable arrangement for a permanent program that is to be primarily financed from tax revenues. The design for the next phase of both programs already has a larger role for local governments. The next three years need to be a period of transition in which an appropriate role is evolved for the kabupaten and municipality governments, which are expected to be the principal funders of the programs and for the kecamatan and kelurahan governments, which will be the level at which some of the infrastructure will operate.

But at the same time it is crucial not to lose the emphasis on the empowerment/ participation of the poor and on the transparency and honesty of both programs. Two elements were crucial in the success in attaining these objectives. First, poor non-officials dominated the committees that proposed projects to be executed with program funds and the committees that selected projects for funding. This in itself was an innovation since government officials have traditionally dominated such local committees. Second, there were independent supporting, reporting and inspection organizations, drawn from the non-governmental organizations – both profit making and non-profit NGO – which could report directly and independently to both national government and donor offices in Jakarta. These institutions were not under the control of local committees or officials. There was therefore a much greater risk that malfeasance would quickly be exposed, a successful deterrent against such malfeasance or KKN. The machinery that was built up to some extent rivaled the formal government organization and was quite costly. But it also produced results – lower costs, more satisfaction with the results and less corruption as best one can tell. But experience indicates where some requirements for reporting and supervision were excessive and can be cut back. Integration with existing government machinery can produce further cost savings. But two basic principles can and should be preserved:

- Minimum required representation of the poor and women at all levels of the committee structure that proposes and selects projects for funding;
- A monitoring system that is not under the control of the executing agencies at any level.

Most governments recognize the need for independent monitoring. Indonesia has an independent auditing function that operates at the national level and is concerned with fraud, theft and other gross violations. These programs require a monitoring function which goes all

the way down to the sub-district level and which checks not only on legal violations but also monitors whether the program is achieving its goals and how it can be improved. The monitoring system that has evolved has worked well and can be continued on a reduced scale and level of detail to continue to assure that these two programs operate efficiently and honestly.

#### **d. Joint financing of the expanded programs**

Until now both KDP and UPP have been fully funded by the World Bank. But of course any program that relies wholly on donor funding is not sustainable. In any case the World Bank is already shifting to partial funding for the KDP. It has insisted that it will fund kecamatan entering the program only if 70-80% of the program funds are provided by the relevant kabupaten. The World Bank will provide the remaining 20-30% of program funds and all the funding for the technical assistance and monitoring functions. The KDP program has become sufficiently popular that enough kabupaten funding is available from non-World Bank sources to meet this requirement for co-financing. But co-financing currently applies only to kecamatan that are new to the program this year. Under the proposal made above additional kecamatan will remain in the KDP program, most of them the poorest kecamatan that have graduated or will be graduating from KDP. No only are the kecamatan poor, they also tend to be in the poorest kabupaten [and the poorest Provinces]. These poorer areas may well be unable to finance a continuing program, while also funding kecamatan that are being added to KDP. But it is precisely the poor kecamatan in the poor kabupaten that most need programs like KDP and can most benefit from them. It is therefore desirable to use special matching grants from the National government ["DAK"] to provide an incentive for both District and Sub-District governments to continue to participate in the program. Finally, provision of funding by the national government increases the likelihood that the World Bank will be willing to finance expanded programs for several more years.

A similar matching arrangement is justified for the UPP, although some urban areas are quite rich and could well afford to fund any very poor kelurahan they include. The purpose of offering matching funds from donors and the National Government to cities under UPP as well is to provide a strong incentive to continue activities in very poor areas that often lack the political strength to obtain a fair share of infrastructure services and employment.

With a central focus on poverty alleviation **both KDP and UPP are eligible for concessional funding from both World Bank [IDA] and ADB [ADF]. Indonesia currently could lose up to \$300 million of such concessional IDA funding unless there is quick agreement on an appropriate set of policies and programs to reduce poverty.** Expansion of KDP and UPP could help obtain such highly concessional funds. The ADB at one time was interested in supporting an Urban Poverty Program in Sumatra and possibly other Provinces, and that should also be under concessional ADF funding. Additional borrowing for these purposes is justified because both IAD and ADF have a large grant component. Both will also increase growth and therefore generate resources for the limited debt servicing required if they give greater emphasis to infrastructure development and employment, as recommended.

In short, what is proposed **in order to make both KDP and UPP sustainable over the longer term is that they be financed by** a combination of:

**World Bank [or ADB] funding** for 20-30% of program costs and all supervision and Technical Assistance [TA] costs; plus special

**National Government matching [DAK] funds** for 20-30% of program costs; provided that the **kabupaten provides the remaining 40-60% of program funds**. Whether a kecamatan is eligible for 20% or 30% of World Bank or National Government funds would depend on whether the relevant kabupaten is relatively rich or poor.

### **C. Financing Poverty Alleviation Programs**

Shortage of resources for development programs has been an increasing problem since the beginning of the Crisis. This problem has become more serious with the transfer of resources from the National government to the kabupaten/Districts. Finally the increasing debt service burden has left fewer resources for new initiatives. The question naturally arises how are programs for MSME and for local, labor-intensive infrastructure development to be financed.

#### **1. Limit programs to those with high priority and quick payoff**

The first point to recognize is that the perfect is often the enemy of the good. This applies with special force to programs for SME. Many programs have been assembled without attention to priorities. They include proposals for elaborate new structures, for comprehensive and expensive new services and institutions, and for highly subsidized credit programs, all of which are bound to be expensive. As a result many of the very ambitious proposals are never funded or implemented. It would be far better to propose a more modest program, concentrating on aspects that are known to be successful and to have a quick payoff. The infrastructure elements of the KDP have been efficiently implemented with minimal loss of resources due to KKN. The reach of the program can readily be expanded especially by continuing in those areas with 3 years of successful experience. To keep them in the program is virtually certain to have a quick and significant payoff. On the other hand proposals for comprehensive and ambitious government programs to provide TA and services to SME throughout Indonesia will take years to organize, and success is far from assured. Given current resource constraints better to make a decision now to postpone such ambitious projects and build slowly on existing, successful pilot programs.

#### **2. Scale down or eliminate programs that have not been successful to free up funds**

Over the last 20 years there have been a number of credit programs that have had low repayment rates, despite highly subsidized interest rates. Moreover the same programs have often had substantial evidence of KKN. Many of these credit programs have also required periodic debt write-offs. Both types of credit program have been a continuing drain on resources. Ending them can free up funds year-after-year for higher priority projects. Several such programs have been recommended for phasing out.

#### **3. Draw on highly concessional donor funding to the maximum extent possible**

Indonesia continues to borrow at commercial or near-commercial rates. At the same time both World Bank and ADB have made it clear that substantial additional funds could be available on concessional<sup>12</sup> terms in support of an integrated credible poverty alleviation program. Under

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<sup>12</sup> "Concessional" means that the fee or interest rate tends to be around 1%, while the Indonesian government currently pays more than ten times as much on other borrowing; that there is a "grace period" of 10 years when no payment of principal is required; and that the period over which the loan has to be paid back stretches to 40 years.



such concessional terms the debt burden increases by substantially less than the funds provided. At the same time a poverty program that develops MSME and infrastructure, and creates productive jobs, would increase national income and provide the wherewithal to service the limited additional debt.

#### **4. Use matching grants to mobilize kabupaten funds for high priority development**

While decentralization means that the National Government has fewer resources it obviously means that Provincial and especially Kabupaten governments have more. But inevitably the most pressing pressures on the latter will be to fund government salaries, and operating and capital costs. The pressure the poor are able to exert on governments is quite weak almost everywhere and is especially weak on new governments pre-occupied with establishing themselves. Moreover poverty alleviation programs are especially needed in poorest areas, least able to afford them. In all Federal or decentralized systems one very effective tool of the National government is the matching grant, used to:

- make National Government resources go further,
- provide incentives to local government to pay attention to national priorities and
- to help level the playing field between rich and poor areas, by providing larger allocations to poorer regions.

The National government of Indonesia, faced with a new fiscal reality, needs to develop a well-designed matching grants system, using special allocations [DAK] to strongly encourage Provincial and District governments to devote some of their own resources to national programs for poverty alleviation. One such program would foster MSME and also labor intensive local infrastructure development programs. Details of this approach have already been discussed under various sections above.

Decentralization can lead to an Argentine outcome where Provincial and other local governments use their freedom and power to assure short-term political gains by borrowing and spending recklessly, leaving it to future governments to deal with the resulting problems. Or it can lead to an Indian outcome where some States use their power to develop new sources of income and win elections thanks to their excellent economic performance. The National government can use matching funds to provide an incentive for the latter outcome, by offering additional resources for Provinces and kabupaten who follow sensible economic policies and by limiting the borrowing that the Provinces can undertake.

**In short: the additional funding required would be minimized by focusing on projects that have high priority and quick payoff; some of the funding can be made available by scaling down or discontinuing lower priority or ineffective programs; additional resources can be obtained on a concessional loan basis from the World Bank and the ADB for a coherent poverty alleviation effort; and the National Government can leverage its own resources by providing matching grants to Provincial and District governments for national programs.**

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The result is that these loans are like getting a grant for 2/3 to 3/4 of the face value of the loan. Only 1/3 to 1/4 is a true loan.